CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
STATEMENT OF INVESTMENT POLICY

FOR
HYBRID AND HEDGE FUND INVESTMENT VEHICLES – EXTERNALLY MANAGED

February 18, 2003

This Policy is effective immediately upon adoption and supersedes all previous hybrid and hedge fund investment policies.

I. PURPOSE

This document sets forth the investment policy ("the Policy") for Global Equity, with respect to Hedge Funds and Hybrid Investment Vehicles, including the Joint Global Equity/Alternative Investment Management (AIM) Hedge Fund Program ("the Program"). In addition, this Policy applies to those Hybrid Investment Vehicles enumerated in Section V.B. The design of this Policy ensures that investors, managers, consultants, or other participants selected by the California Public Employees' Retirement System ("the System") take prudent and careful action while managing the Program. Additionally, use of this Policy provides assurance that there is sufficient flexibility in controlling investment risks and returns associated with this segment of the global capital markets.

II. STRATEGIC OBJECTIVE

Broadening the opportunity set of the System's investment portfolio for achieving investment returns not available in traditional public markets investments is the strategic objective of investments in hybrid investment vehicles ("Hybrids") and Hedge Funds

Hybrids and Hedge Funds are offered in a limited partnership or limited liability company (LLC) form, when the majority of the underlying investments are publicly traded. Hybrids and Hedge Funds may include, but are not limited to, corporate governance funds, arbitrage funds, derivative strategies, strategic block investment funds, or crossover funds where the underlying investments consist of both public and private investments.

Hybrids and Hedge Funds shall be selected to accomplish the following:

A. Enhance the System's long-term total return.

B. Hedge against long-term liabilities.

C. Provide diversification to the System's overall investment program.

D. Consider solely the interest of the System's participants and their beneficiaries in accordance with California State Law.

III. RESPONSIBILITIES AND DELEGATIONS

A. The **System's Investment Committee** ("the Investment Committee") is responsible for approving and amending this Policy. The Investment Committee delegates the responsibility for administering Hybrid and Hedge Funds to the System's Investment Staff through the Delegation of Authority (Delegation Nos. 89-13 and 95-50).

B. The **System's Investment Staff's** ("the Staff") duties include, but are not limited to, the following responsibilities:

1. Developing and recommending this Policy to the Investment Committee.

2. Developing and maintaining a procedures manual, subject to periodic reviews and updates, outlining Staff operational procedures used in implementing this Policy.

3. Implementing and adhering to this Policy.

4. Evaluating hybrid and hedge fund investment opportunities, including the possibility of obtaining equity stakes in management firms under this strategy, and recommending actions for new investments to the Investment Committee With respect to the Joint AIM/Global Public Equity Hedge Fund Program only, Staff will bring to the Investment Committee for approval any investment in excess of $200 million.

5. Monitoring selected Investment Partner(s) to determine if the partners' actions and investment results are consistent with the System's manager monitoring policies. Monitoring may be accomplished through a Hybrid Investment Consultant or a Hedge Fund Strategic Partner(s) or Staff.

6. Reporting to the Investment Committee concerns, problems, material changes, and all violations of Guidelines and Policies immediately and in writing, along with explanations and appropriate recommendations for corrective action.

7. For accounting purposes, investments made in private equity securities shall be valued based upon generally accepted methods for such securities including those methods used by the AIM program.

C. The **General Partner(s)** is responsible for all aspects of portfolio management as set forth in the investment partner's contract with the System and shall fulfill the following duties:

1. Communicate with Staff as needed regarding investment strategy and investment results. The investment partner(s) is expected to monitor, analyze, and evaluate performance relative to the agreed-upon benchmark.

2. Cooperate fully with the System's Staff, Custodian, and Hybrid Investment Consultant or Hedge Fund Strategic Partner(s) on requests for information.

3. Comply completely with the System's mandated reporting requirements, including but not limited to, accounting for fees, expenses, capital investments, and dispositions.

D. The **Hybrid Investment Consultant and Hedge Fund Strategic Partner(s)** shall conduct the initial screening of hybrid investments, perform due diligence and evaluate hybrid investment vehicle partnerships and hedge funds as directed by the Staff, prepare independent recommendations regarding partnerships for the Investment Committee and monitor and evaluate performance relative to individual benchmarks and this Policy, in accordance with its contract with the System. In addition, partner(s) may also invest side by side with CalPERS in selected hedge funds.

IV. PERFORMANCE OBJECTIVE

Hybrids and Hedge Funds are highly specialized investments; therefore, the System shall establish performance objectives for each individual Hybrid or Hedge Investment vehicle. These objectives shall be set at levels that are consistent with the strategy employed by the hybrid or hedge fund manager.

Joint AIM/Global Equity Program

1. Target Level Risk

   The target risk level shall be no greater than the expected volatility of CalPERS' Internal Wilshire 2500 Equity Index Fund.

2. The Return Target

   The return target shall be the return of the one-year U.S. Treasury Bill rate plus 7% over a full market cycle (three to five years). On an annual basis and for purposes of performance appraisals, the return target shall be 50% of the return of the Wilshire 2500, plus 50% of the return of the one-year U.S. Treasury Bill rate plus 7%.

3. Liquidity

   In general, expected liquidity for the Program and for individual investments shall be on an annual basis unless investment merits warrant otherwise.

4. Expected Decline in Net Asset Value

   It is expected that the decline in net asset value for the Program will not exceed 10% in any one month.

Return Target for Equity Ownership in Hybrid and Hedge Fund Investment Vehicles

The return target for equity stakes in Hybrid and Hedge Fund Investment Vehicles shall be consistent with the return targets for similar investments in the AIM Program or the Manager Development Program.

V. INVESTMENT APPROACHES AND PARAMETERS

A. Approach

1. Hybrids and Hedge Funds shall be alternatives to other traditional active management vehicles in the Public Markets and AIM Investment Programs. They may include exposure to leverage or short selling of securities or both. Funds for investment in Hybrids and Hedge Funds may come from the active or passive management allocation in each asset

category. Hybrids and Hedge Funds shall not exceed twenty-five percent of the total active management allocation on a market value basis in each asset category.

2. The Program shall use Hybrids and Hedge Funds opportunistically to gain the attractive risk-to-reward characteristics of specialized and unique investment strategies. Hybrids and Hedge Funds are not intended to be a substitute for investment strategies generally available in standard agency agreement format.

3. The Program shall implement Hybrids and Hedge Funds through partnerships, funds, or other formation structures, e.g., limited liability companies (LLCs), where the general partner(s) or fund manager(s) have expertise in the specified mandates and in related areas material to the success of each investment strategy. The justifications for a limited partnership or LLC structure include, but are not limited to, the following:

   a. Financial Firewall: The limited liability of a partnership or LLC arrangement is important since Hybrids and Hedge Funds sometimes use derivatives and leverage. The System, as a limited partner, has the benefit of this limited liability.

   b. Access Unique Approaches with Limited Liquidity: The key to successful Hybrid and Hedge Fund investing is in selecting vehicles where the specialization of the investment is sufficiently unique that the partnership or LLC structure is justified in limiting asset growth in the strategy, ensuring a proper investment time horizon, and protecting the System from the vagaries of other investors who may not be like-minded. The goal is to ensure that the approaches selected for recommendation do not mirror traditional active management. The fees and expenses of investing in Hybrids and Hedge Funds may be higher than traditional active management. The System shall not fund Hybrid and Hedge Funds that simply invest in traditional active management approaches at higher fees.

   c. Access Unique Talent: The specialized and focused nature of Hybrids and Hedge Funds often requires more specialized investment skills than those needed for traditional active management. Some of these investment professionals manage money only in the partnership format or LLC structure.

4. The negotiation of terms in Hybrids and Hedge Funds shall protect the interests of the System, and shall address at a minimum the following issues:

   a. Alignment of Interests: Vehicle terms including fees shall be negotiated to ensure the alignment of the General Partner's interest with the System. The management fee, carried interest, performance objective, return of capital, lock-up period, clawbacks, and other relevant terms shall protect the System in the event of adverse performance results, while ensuring that the limited liability status is maintained. Where appropriate, a return of capital commitments shall be negotiated.

   b. Leverage: It is recognized that Hybrids and Hedge Funds may expose the System's assets to leverage, meaning that a partnership's market exposure may exceed the market value-adjusted capital commitment by the amount of borrowed capital. Negotiation of hybrid investment vehicle terms shall consider The System's stated hybrid level of leverage necessary for achieving the investment's stated objectives without exposing the System to undue risk. The partnership or LLC agreements shall detail the amount of leverage and monitor leverage on a case-by-case basis and in the aggregate, to ensure that expected and realized returns are sufficient and achievable to compensate for the risk incurred. For the AIM/Global Equity Hedge Fund Program, the program limit on leverage shall not exceed 100% of the existing capital without prior Investment Committee approval although individual hedge funds within the program may exceed 100% leverage. For individual funds outside of the AIM/Global Equity Hedge Fund Program, the 100% leverage limitation shall apply.

   c. Reporting Requirements: To appropriately account for fees, individual expenses, invested capital, and any other items affecting the investment, Staff shall prescribe a standard reporting format, which all the General Partners shall follow.

5. The Staff and consultant shall continually review the efficacy of Hybrid and Hedge Fund investment vehicles. The Staff shall present a formal review of the approach to the Investment Committee at least every three years.

B. Investment Selection

1. Hybrids and Hedge Funds may be selected if they enhance the investment program within each asset class achieving the overall asset class investment goal. Hybrids and Hedge Funds may include investments in domestic and international equity and fixed income asset classes in strategies that may include, but are not limited to, the following areas but must be subject to asset class restrictions:

    a. Relative Value Funds

    b. Market Neutral Funds

    c. Arbitrage Funds

    d. Corporate Governance Funds

    e. Derivative-Based Strategy Funds

    f. Concentrated or Strategic Block Funds

    g. Crossover Funds (where public securities and private investments are included in the partnership)

    h. Long/Short Equity Funds

2. The following hedge fund investment styles will be considered for the Joint Global Equity/AIM Program:

    a. Convertible Arbitrage

    b. Statistical Arbitrage

    c. Merger/Transaction Arbitrage

    d. Long/Short Equity Funds

    e. Cross Over Funds

f. Market Neutral

3. The Staff shall develop and maintain selection guidelines for Hybrids and Hedge Funds to include the following:

   a. Minimum requirements with respect to the following:

      (1) General Partner Investment Experience

      (2) Basic Investment Vehicle Terms

      (3) Investment Goals and Objectives

      (4) Degree of Leverage

   b. Performance Criteria

   c. Due Diligence Process

   d. Legal Constraints or Requirements

   e. Hedge fund funding

   f. Reporting Requirements

   g. Quality control processes including, but not limited to, investment monitoring and risk control

   h. Other relevant parameters that may apply

4. Staff shall review opportunities to obtain an equity stake in Hybrid and Hedge Fund managers and make recommendations to the Investment Committee as appropriate. CalPERS shall not take equity stakes in managers without Investment Committee approval, regardless of the value of assets CalPERS places with the Fund. A separate portfolio will be established to provide for performance measurement of CalPERS' equity stakes in Hybrid and Hedge Fund managers.

5. Except as is consistent with Staff's responsibilities and delegations under Section III.B.4, the Staff, the Hybrid Investment Consultant and the Hedge Fund Strategic Partner(s) shall review opportunities in Hybrids and Hedge

Funds and make recommendations to the Investment Committee as appropriate.

C. Investment Parameters

Investment partner(s) in Hybrids and Hedge Funds shall operate under a limited partnership agreement, or other similar legal structure, which includes specific, written investment guidelines. The guidelines shall outline the investment partner(s)' investment philosophy and approaches, representative portfolios characteristics, permissible and restricted securities and procedures, and a performance objective commensurate with the investment risk to be incurred.

Implementation of this Program shall comply at all times with the applicable System investment policies.

VI. BENCHMARKS

Due to the wide range of markets in which these investments shall be made, appropriate benchmarks shall be established for each specific hybrid and hedge fund investment vehicle. They shall reflect the investment opportunity set or risk profile of each investment. These benchmarks shall be established prior to investment and shall be documented with each hybrid and hedge fund manager.

VII. GENERAL

A. This Policy contains a glossary of terms in Section VIII of this document

B. Investors, managers, consultants, or other participants selected by the System shall make all calculations and computations on a fair-market-value basis as recorded by the System's Custodian. In the case of private investments, calculations and computations shall be made consistent with the partnership agreement, unless otherwise approved by the Investment Committee.

VIII. GLOSSARY OF TERMS

The following Glossary of Terms contains definitions also referenced in the System's Master Glossary of Terms.

Arbitrage Funds – These are hedge funds that buy and sell similar securities to take advantage of price differentials that may lead to a profit. For example these strategies may be associated with a corporate announcement, such as merger arbitrage, to earn a rate of return that is independent of the general stock market. As another example, these funds buy and sell the securities of the same company, such as convertible arbitrage, to earn a rate of return that is independent of the general stock market.

Clawbacks – Provisions allowing a review of the total profit distribution from a partnership at the end of the investment term. Clawback provisions facilitate the recapture of overpayments to the general partners if they received more than their stated carried interest.

Concentrated or Strategic Block Funds – These are funds that focus their investments in relatively few companies. Their intent is usually to gain Board of Directors representation or to sell their investment stake back to the company at a premium.

Convertible Arbitrage - Generally involves the purchase of a convertible bond while simultaneously hedging the equity component of the bond to lock in a higher-yielding instrument than straight debt.

Corporate Governance Funds – These are funds that effect changes in both the corporate governance and operating policies of public companies with the expectation of improved stock price performance.

Crossover Funds – These are hedge funds that contain both a public markets component and a private markets component. Generally, the public market component is much larger and is in the form of a long/short strategy

Custodian – A bank or other financial institution providing the custody of stock certificates and other assets of an institutional investor.

Derivative – An instrument whose value, usefulness, and marketability is dependent upon or derives from an underlying asset. Classes of derivatives include futures contracts, options, currency forward contracts, swaps, and options on futures.

Derivative Base Strategies – These are funds that invest in markets typically dominated by derivative instruments. For example, commodity funds typically invest in futures contracts and currency funds typically invest in forward contracts and swap agreements.

Derivatives Policy –the System's Statement of Derivatives Policy.

External Manager – A money management firm retained under contract by the System.

Financial Firewall – The legal protection from financial liability extending beyond the value of the investment in the Limited Liability Company or Limited Partnership.

General Partner – The manager of a limited partnership. The general partner has full responsibility for investing the capital. The general partner also bears personal liability for any lawsuits that arise from the investment's activities, but is often indemnified by the fund.

Hybrid Investment Consultant and Hedge Fund Strategic Partner(s) – One or more partner(s) will be chosen to help develop the Joint AIM/Global Equity Hedge Fund Program. The partner(s) may be responsible for screening, due diligence, advice on selection, monitoring, and risk management

Hybrid Investments - Investments that are offered in a limited partnership or limited liability corporate (LLC) form, where the underlying investments in the majority are publicly traded. Hybrid investments may include, but are not limited to, corporate governance funds, hedge funds, arbitrage funds, derivative strategies, strategic block investment funds, or crossover funds where the underlying investments consist of both public and private investments.

Hybrid Investment Vehicle – An investment typically structured as a limited partnership that is expected to achieve investment returns significantly above those available in traditional public market investments. Investments may be in domestic, international, public and private market equity, or fixed income securities, financial derivatives, short positions in publicly traded domestic and international equity and fixed income securities, and may employ leverage.

Investment Partner/Limited Partner – An investor in a limited partnership. Limited partners provide the capital, but have no direct involvement in the management of the fund. Limited partners have limited liability but also have limited control over the management of the fund.

Leverage – A condition where a portfolio's market obligation may exceed the market-value-adjusted capital commitment by the amount of borrowed capital (debt).

Limited Liability Company (LLC) – An alternative structure to a limited partnership. It is often described as a hybrid between a corporation and a partnership because it offers limited liability like a corporation and single taxation on income like a partnership.

Limited Partnership – The most common format used in structuring private equity investments. Limited partners provide the capital, but have no direct involvement in the management of the fund. Limited Partners have limited liability but also have limited control over the management of the fund.

Liquid/Liquidity – The ability to convert quickly a particular investment into cash at a low transaction cost.

Long/Short Equity Funds – These are hedge funds that establish both long equity positions and short equity positions to extract the maximum value from their investment information set.

Market Neutral Funds – These are hedge funds that attempt to remove or neutralize systematic market and industry risk while focusing on stock selection risk.

Merger/Transaction Arbitrage - These are hedge funds that make investments in companies that have announced a significant corporate transaction such as a merger, acquisition, spinoff, etc. The strategy is to capture a market premium for bearing the risk that the transaction will not be completed.

Partnership Agreement – Legal document that sets forth the terms and conditions of a private equity or hybrid investment vehicle. The partnership agreement also establishes the roles of general and limited partners.

Policy – The System's Investment Policy for Hybrid and Hedge Fund Investment Vehicles – Externally Managed.

Relative Value Funds – These are funds that compare the prices of two similar securities and buy the security that appears relatively cheap and sells the security that appears relatively expensive.

Statistical Arbitrage - These are hedge funds that use quantitative models to remove all common sources of risk from an equity portfolio (size, book to market value, market, dividend yield, etc.) so that only stock selection risk remains. Different from market neutral managers in that quantitative factor models are used to identify and minimize risk.